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## **June Market Perspective:**

“The only difference between death and taxes is that death doesn't get worse every time Congress meets.” - Will Rogers

The Biden Administration has proposed two pieces of legislation, the [American Jobs Plan](#) and the [American Families Plan](#), that include a range of new spending proposals along with personal and corporate tax increases. For those keeping track at home, the American Jobs Plan is the name of the broad-based infrastructure and corporate tax plan proposed by the Biden Administration, whereas the American Families Plan focuses on subsidies for education, childcare, paid leave, nutrition, and a range of personal tax proposals.

At the time of writing, Congress is focused (unsuccessfully so far) on finding a bipartisan compromise on infrastructure investment. A compromise infrastructure bill could push tax legislation into the fall, but it is also possible that Democrats will soon abandon efforts to compromise on an infrastructure bill and instead introduce a narrow tax bill over the next few weeks. Even that path has hurdles, as there has been some public resistance by Democratic senators to parts of Biden's tax proposal.

Although no single compromise plan has yet to be agreed upon (bipartisan or otherwise), it is likely that some sort of tax legislation will be introduced and passed this year. Additionally, it is possible that some provisions, like higher capital gains tax rates, will be made retroactive to prevent the realization of gains at current lower rates. President Biden's proposed budget, for example, retroactively applies higher capital gains tax rates to April 28<sup>th</sup>, 2021. Congress will write its own bill, but investors should be aware that the retroactive application of higher capital gains rates will be on the table.

In the face of such uncertainty, we have focused on the principal components of President Biden's corporate and personal tax proposals in this report. The Biden Administration has set forth priorities through the American Jobs Plan and American Families Plan, but Congress, not the President, writes legislation. In that regard, we urge investors to start considering the impact of these proposed changes but caution against overreaction at this time.

Some of the proposed changes — were they to come to fruition — could lead to important changes in investment strategy, asset location, and estate planning. We will continue to communicate the status of these proposals throughout 2021 through our publications and

livestreams, and also look forward to working with you directly to account for them in your investment plans.

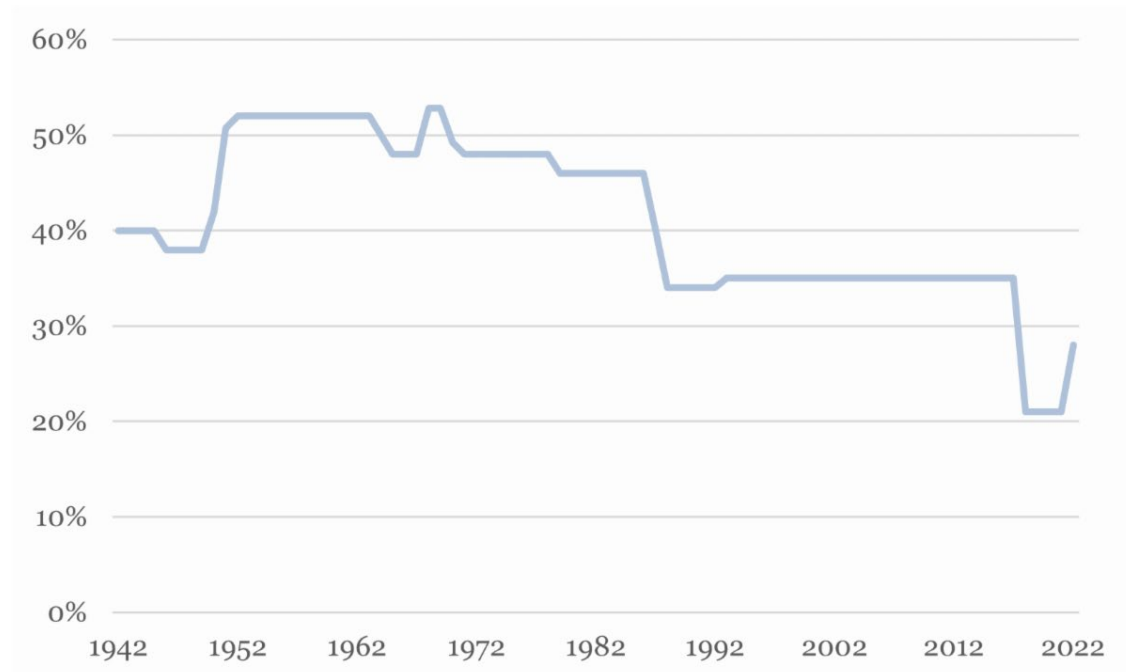
## Corporate Taxes

The Biden Administration has included corporate tax reforms within the infrastructure-focused American Jobs Plan. The proposal calls for:

1. an increase in the federal corporate tax rate from 21% to 28%,
2. a global minimum tax on corporations, and
3. ending various loopholes that US multinational corporations use to lower their effective US tax rate.

The federal corporate tax rate last changed in 2017, when it was lowered from 35% to the current 21%.

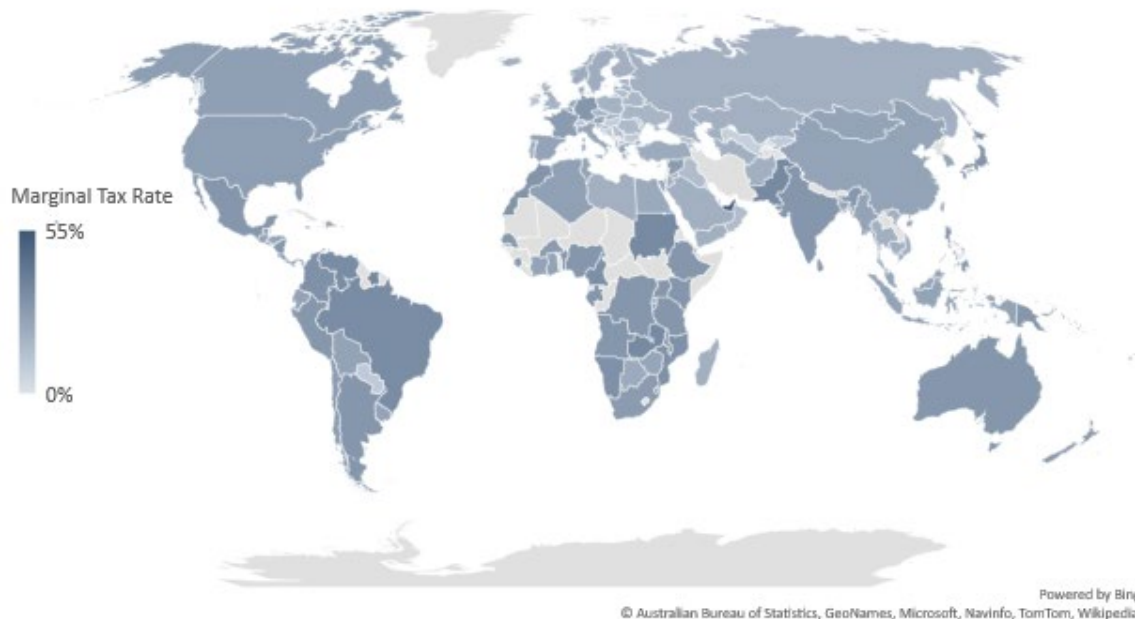
**Fig. 1: Corporate Tax Rate, 1942-2021**



Sources: Joseph Pechman. Federal Tax Policy. Washington, D.C.: Brookings Institution, 1987; Internal Revenue Service, Publication 542, 1993-2006; Internal Revenue Service, Instructions for Form 1120, 2007-2019. Includes surcharge of 10 percent in 1968 and 1969 and 2.5 percent in 1970.

A 28% federal corporate tax rate would qualify as fairly low from a historical perspective (Fig. 1), as the federal corporate tax rate has ranged between 30-50% since the 1930s. On the other hand, even at 21% the US has a fairly high corporate tax rate from a global perspective (Fig. 2). The average corporate tax rate in the EU, for example, is about 20%. With state and local taxes included, the average marginal tax rate for US corporations is currently around 27%.

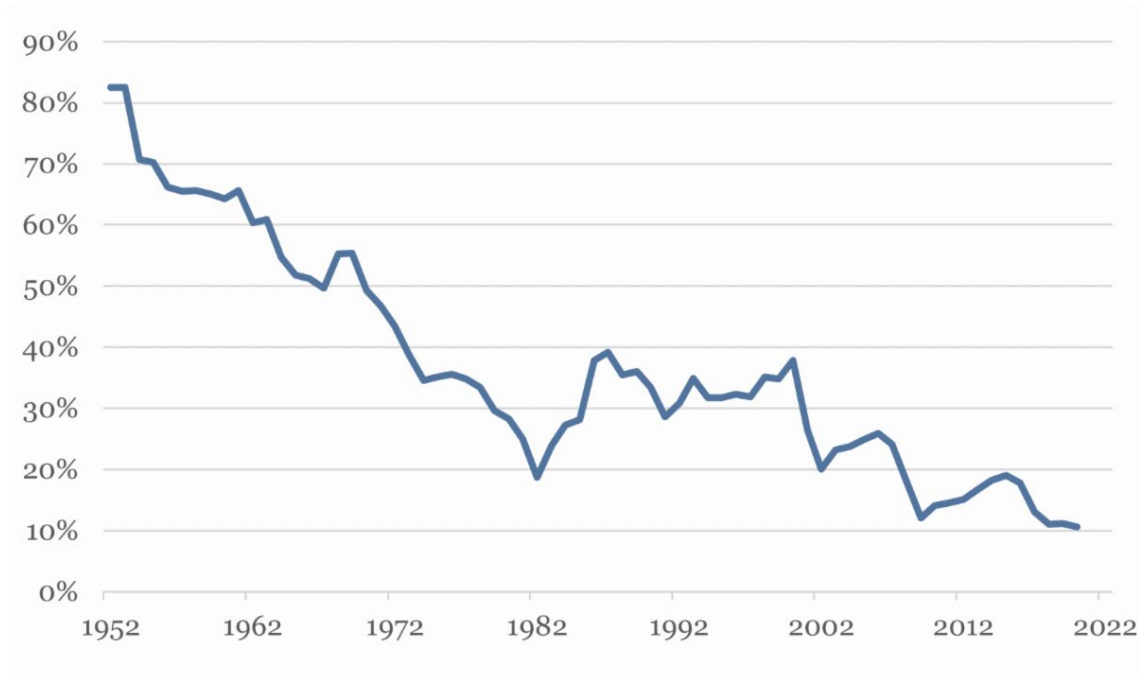
**Fig. 2: Global Corporate Tax Rates**



Sources: KPMG, Mill Creek

There is a distinction, however, between tax rates as specified in the tax code and actual taxes paid. It is likely that a higher corporate tax rate will lead to higher taxes paid (thereby reducing earnings available for investors and leading to lower company valuations) but the historical relationship has not been quite so direct. For instance, the tax code provides some discretion that corporations can use in deciding when to report income (e.g. foreign sales) and companies can shift to tax-deductible debt financing if the cost of equity financing has increased. Therefore, the effective tax rate might be different than the statutory rate (Fig. 3). Globally, the effective tax currently paid by US corporations is roughly in line with the world-wide average.

**Fig. 3: Effective US Corporate Tax Rate (for firms with profits)**



Sources: Source: U.S. Bureau of Economic Analysis, Corporate Profits After Tax (without IVA and CCAdj) [CP], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CP>, May 25, 2021. Mill Creek.

Realistically, the American Jobs Plan proposals will likely lead to slightly higher effective tax rates for US corporations, but not equal to statutory rate change unless major changes are made to reduce available deductions and credits currently in the code. Additionally, US corporations will, on the margin, have a greater incentive to keep profits overseas and invest in international operations, lowering the effective tax rate paid in the US. The “global corporate minimum tax” proposed in the American Jobs Plan is an attempt to keep the US from losing too much competitiveness in that regard, but it is not clear whether other countries — many of whom use lower corporate tax rates to attract capital — are eager to sign on. The devil, as always, will be in the details of the final legislation.

## Personal Taxes

The American Families Plan includes several changes to the personal tax code that impact higher-income individuals and investors:

1. Equalizing the rate paid on investment returns and wages for households making over \$1 million to 39.6% percent rate on all their income, (43.4% after including the Obamacare surcharge),
2. End the practice of “stepping-up” the basis for gains in excess of \$1 million,
3. Raising the top marginal incomes tax rate from 37% to 39.6%,

4. Removing the “carried interest loophole” for hedge fund and private equity general partners,
5. Limit the ability to defer taxation on real estate property exchanges for gains greater than \$500k, and
6. Apply the 3.8% Medicare tax consistently on earnings above \$400k.

Our focus in this report will be on the first and second components, as capital gains rates and the tax treatment of inherited assets potentially both impact market valuations and investment strategy.

## Inherited Assets

Although it has received less media attention, the proposal to end a basis step-up for inherited assets will have significant consequences for managing a higher capital gains tax. As a brief explainer, an estate might currently pay estate taxes on the overall value of the estate, but neither the estate nor the inheritors pay capital gains tax on the difference between the cost basis and market value of inherited assets. Under the Biden plan, those capital gains will be taxed unless the assets are donated to charity.

This is how the American Families Plan fact sheet explains the proposal:

Moreover, the President would eliminate the loophole that allows the wealthiest Americans to entirely escape tax on their wealth by passing it down to heirs. Today, our tax laws allow these accumulated gains to be passed down across generations untaxed, exacerbating inequality. The President’s plan will close this loophole, ending the practice of “stepping-up” the basis for gains in excess of \$1 million (\$2.5 million per couple when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity. The reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business.

To illustrate how this might work, let’s assume Sara purchased \$100 worth of Amazon a few years ago that has now appreciated to \$500. Sara, sadly, will die tomorrow. If she sells the stock today, she owes capital gains tax on the \$400 gain. Conversely, if she passes away with the unrealized gain, the estate will not owe tax on the unrealized gains and her beneficiary will inherit it at a basis equal to the current market value. Under Biden’s proposal, her estate (or the inheritors of the assets — it is not clear where the liability would fall) would pay tax on the \$400 gain.

Eliminating the basis step up for inherited assets is more challenging in practice than in theory. Aside from the family farm and business considerations that Biden’s proposal addresses, it can be difficult or impossible to determine an accurate basis for assets that have been owned for decades and to fairly value private holdings. These are details that would have to be worked out during the legislative process.

## Capital Gains

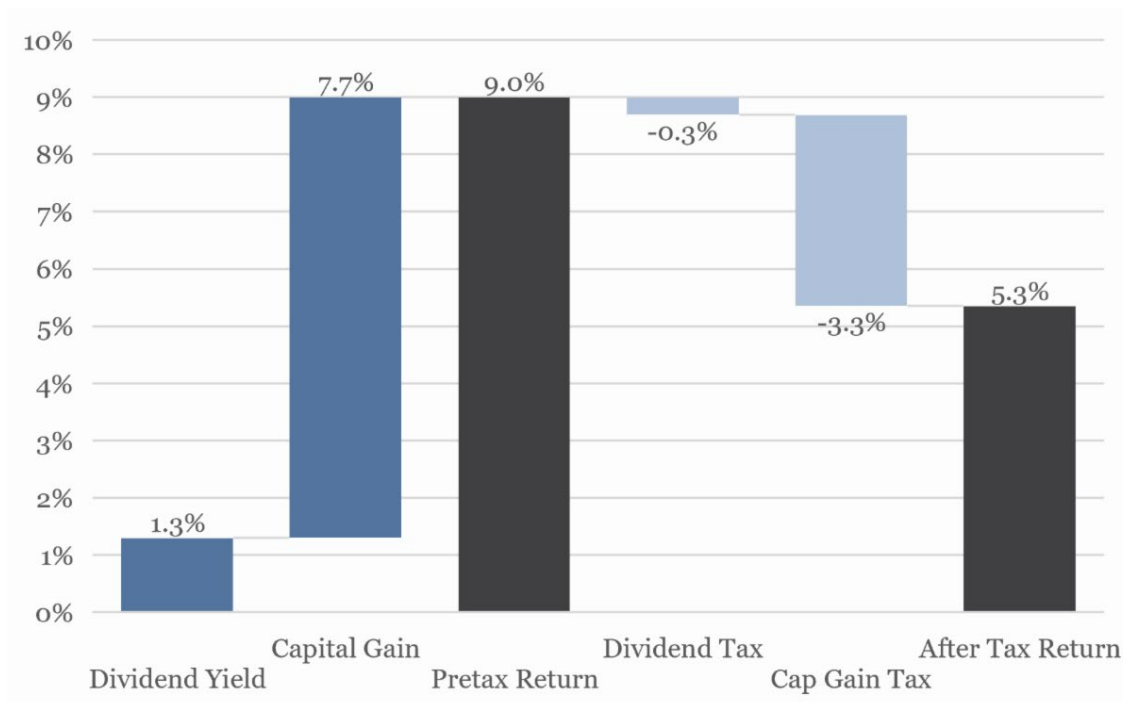
The proposed increase in the capital gains rate applies to families with over \$1 million of income per year. From the fact sheet:

The President’s tax reform will end one of the most unfair aspects of our tax system: that the tax rate the wealthy pay on capital gains and dividends is less than the tax rate that many middle-class families pay on their wages. Households making over \$1 million—the top 0.3 percent of all households—will pay the same 39.6 percent rate on all their income, equalizing the rate paid on investment returns and wages.

It is not clear from this language whether or not the 39.6% rate will apply for all capital gains or operate as a marginal rate for income above \$1 million, but regardless many investors will need to engage in more-specific income planning than they have in the past. There have also been rumors from Washington D.C. that the capital gains tax increase would be effective as of the date that the bill is proposed or signed into law, meaning that some investors would face higher tax rates as early as this summer.

The current proposal to nearly double the capital gains tax for certain investors would have a significant impact on after-tax returns, particularly when combined with a removal of the basis step up on inherited assets. Based on our capital market assumptions, the current tax proposal would reduce after tax annual equity returns by up to 3% on an annualized basis for investors with over \$1 million in annual income. Investors that fall below the \$1 million threshold would see after-tax returns decline by up to 1.5% per year due simply to the inability to defer capital gains and avoid realizing them by receiving the basis step up on inherited assets (Fig. 4).

**Fig. 4: Illustrative Pre- and Post- Tax Returns for Equities Assuming a 43.4% Tax on Capital Gains**



Source: Mill Creek

## Impact on Market Valuations

There's no escaping the significance of the Biden capital gains proposal on taxable equity positions and there is some reason to be concerned that it could impact overall market valuations. While the higher capital gains tax rate would only impact investors with incomes above \$1 million, the removal of the basis step up for inherited assets would impact most individuals and families. Individuals, not institutions, own the majority of equities in the US. To the extent that the Biden tax plan creates an incentive for those families to hold lower equity allocations, market values could decline as the market seeks a new equilibrium.

At the extreme, the market would have to decline 7-10% to “normalize” expected after-tax returns back to current levels for taxable investors if the Biden plan is implemented as proposed. Such an extreme market move is unlikely for several reasons:

1. TINA (There is no alternative): The proposed changes impact public and private equity alike, leaving return-seeking investors with few places to migrate assets.
2. Although individuals own the majority of equities in the US, the tax “response” is mitigated by assets held in tax-advantaged accounts and by institutional investors.
3. Investors are already aware of the proposed tax bill, so the probability-weighted expected outcome has certainly already been priced into the market. It won't be a surprise to anyone when some version of the Biden Administration's tax proposals are passed into law.

## Investment Impact

We can draw some straightforward implications for all investors that come out of the Biden tax proposals:

1. Despite the potential inability to avoid capital gains through the basis step up on inherited assets, we estimate that active tax-loss harvesting strategies and deferring capital gains will continue to enhance returns by 0.5-0.7% per year.
2. Overall tax drag becomes somewhat equalized across asset classes, so tax advantaged accounts become increasingly useful for investments that generate unpredictable income/capital gains, including active public equity managers and hedge fund strategies.
3. Gifting of appreciated assets remains a highly tax-efficient strategy for charitable giving.
4. Income planning takes on enhanced importance for investors near the \$1 million level of total annual income.
5. Capital gains deferral remains valuable to the extent gains are not taxed at the full 43.4% level at the time of inheritance.

Finally, we'll end where we began and reiterate that the current tax proposals are just that — proposals. While it is highly likely that a tax bill will be passed at some point this year, the composition, size, and details of the package remain quite uncertain. We'll continue to communicate updates as negotiations proceed in Washington D.C.

## Save the Date: Mill Creek Tax & Public Policy Panel

**MILL CREEK**

**Tax & Public Policy Panel**

Tuesday, June 8  
10 AM ET

**Libby Cantrill, CFA**  
Managing Director,  
Head of Public Policy  
PIMCO

**Michael James**  
Principal,  
Personal Financial Services  
PwC

**Tom Chapin, CFA**  
Chief Investment Officer  
Mill Creek

**Michael Crook, CAIA**  
Deputy Chief Investment Officer  
Mill Creek

Save the date for our upcoming tax and public policy panel on Tuesday, June 8. We will be joined by industry experts who will weigh in on the Biden Administration's tax policies and discuss how it will impact your portfolio. Guest panelists include Libby Cantrill, Managing Director, Head of Public Policy at PIMCO and Michael James, Principal, Personal Financial Services at PwC.

### **Panelists:**

- **Tom Chapin, CFA**, Chief Investment Officer, Mill Creek
- **Michael Crook, CAIA**, Deputy Chief Investment Officer, Mill Creek
- **Libby Cantrill, CFA**, Managing Director, Head of Public Policy, PIMCO
- **Michael James**, Principal, Personal Financial Services, PwC

**Tuesday, June 8**  
**10 AM ET**

[Register here](#)



## Benchmark Performance

Benchmark Performance by Asset Class						
Benchmark Returns	One	Year to				
	Week	Date	1 Year	3 Years	5 Years	10 Years
Global Equities	1.4%	10.8%	41.8%	14.0%	14.1%	9.7%
US Equities	1.4%	12.3%	43.9%	18.3%	17.4%	14.5%
International Equities	1.2%	10.4%	38.9%	8.4%	9.8%	5.9%
Emerging Market Equities	2.4%	6.0%	49.3%	9.1%	13.6%	4.0%
US Taxable Bond Market	0.3%	-2.3%	-0.4%	4.9%	3.3%	3.3%
US Municipal Bond Market	0.1%	0.3%	2.8%	4.0%	2.7%	3.0%
Hedge Fund Index	0.5%	3.2%	13.4%	4.1%	4.2%	1.7%
Diversified Commodities	2.1%	18.9%	46.2%	2.2%	2.8%	-5.0%
Gold	1.2%	0.3%	10.0%	13.6%	9.4%	2.1%

Key Rates (as of stated date)	6/1/21	1/1/21	6/1/20	6/1/18	6/1/16	6/1/11
US 10-Year Treasury	1.6%	0.9%	0.7%	2.9%	1.8%	2.9%
Barclays Aggregate Bond Index	1.5%	1.1%	1.3%	3.3%	2.2%	2.7%
BBarc Muni 1-10Yr Blend (1-12) Index	0.6%	0.6%	1.1%	2.3%	1.4%	2.1%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Benchmark rates are yield-to-worst.

*This week's contributor: Michael Crook, CAIA.*

*Indices Used: U.S. Large Cap equities: Russell 1000 Index, U.S. Small Cap Equities: Russell 2000 Index, International Developed Equities: MSCI EAFE Index, Emerging Market Equities: MSCI Emerging Markets Index, U.S. Bonds: Barclays Aggregate Bond Index, U.S. 10 Year Treasury Note: Bloomberg 10 Yr. Treasury Note, Municipal Bonds: Barclays Intermediate Municipal Bond Total Return Index, High Yield Bonds: Barclays U.S. High Yield Total Return Index, Oil: Bloomberg WTI Crude Sub-Index Total Return Index, Gold: Bloomberg Gold Sub-Index Total Return Index*

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